

Unsolicited investment advice

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Dear reader, I have no idea who you are or what your financial situation may be, but let me share some simplified points of financial planning, that you may find useful on the off chance that you find yourself with a few bucks to invest.

The market I have to have easy investment advice on hand because I am sometimes introduced at parties as an economist, and people really do ask me where to put their money. Telling them that I wrote my dissertation on non-Bayesian information aggregation schemes doesn't really stop them. Nor are they satisfied when I give them the most simple investment strategy possible: put it all on red!

If that advice is too simple for ya, let me kick it up a level of complexity: put your expendable income into the S&P 500. It's a decent proxy for the entire stock market, and many a study has shown that on average, attempts to beat the market fall behind the market. That's because the sum of all these specialized strategies *are* the market—minus management bonuses and fees.

A pal beat my don't-think-about-it strategy via an "emerging markets" fund that leaves the USA entirely and invested in China and India. So bear in mind that when I say the S&P is the market, I mean one market in particular, and you may decide to instead put your cash in a worldwide fund or a fund focusing on one not-USA market. But unless you really know what you're doing, you're better off investing in a market-wide investment rather than one company.

How does investing in the S&P 500 compare with putting it all on red? Here's a list of numbers that I cut and pasted from Wikipedia:

Year	Annual Return
1994	1.32
1995	37.58
1996	22.96
1997	33.36
1998	28.58
1999	21.04
2000	-9.11
2001	-11.89
2002	-22.10
2003	28.68
2004	10.88
2005	4.91
2006	15.80
2007	5.49
avg	11.96

So during this period, the S& P 500's annual returns averaged 12%, with large variance, and some years of loss.

You can buy the S&P 500 in a few ways. Lots of companies provide a mutual fund keyed to it, or keyed to some similarly broad list of stocks. There is a corporation, stock symbol SPY (pronounced 'spiders'), whose sole purpose is to track the S&P 500 as closely as possible, and thus act as a single-stock equivalent of the S&P 500.

Debt But that 12% long-term average return may not seem very enticing if you have been reading the pundits' predictions of recession and woe for the near-term.

If you are expecting that the stock markets of the world are going to fail you in the near future, then a better alternative is to pay down your debts.

It's safe to assume that you, as a member of society, have some sort of debt. [A regular reader, Ms BCOH of Baltimore, MD, would like you to know that she has no debt of any sort.] U.S. consumer credit (every type of loan that isn't a mortgage, including credit cards, student loans, cars) totals about \$2.5 trillion¹. For comparison, the total of global wealth is \$97.9 trillion². [I almost wrote an entire blog post on the question of what a total global wealth statistic means, and the implications for our concept of value and its change over time. But I scrapped it and leave it as an exercise for the reader.]

From an accounting perspective, paying a debt has exactly the same effect as investing in a fixed-rate investment. If you have a loan for \$ x that bills you 5% interest, then every year you're flushing $\$x \times 5\%$ down the toilet. By paying off some portion of that, then you're holding on to a few dollars instead of sending them out to the ocean.

I get the impression that people generally understand this with credit card debt, and are very clear that paying off any balance will save them money. For other types of loans, including student loans and mortgages, many folks seem to take the monthly amount flushed as fixed. It ain't.

¹<http://www.federalreserve.gov/RELEASES/g19/current/>

²http://www.bcg.com/about_bcg/media_center/press_releases.jsp?id=2423

For student loans, if it's federally-backed—and most of them still are—then there can be no prepayment penalty. For mortgages, the general standard is that you can pay off the mortgage principal early (with no fees); relatively shady dealers may charge you for the privilege.

Interest is always charged on the remaining principal for the loan, whatever that may be. So if you pay off D dollars on a loan with $n\%$ interest, then you will definitely be flushing $D \times n\%$ less interest down the toilet every year, but how that looks depends on the type of loan. An amortized payment scheme has a fixed monthly payment, but the percentage that repays the loan and the percentage that's flushed down the interest toilet changes every month; if you make an early payment then the percentage that you don't lose goes down accordingly. Other payment schemes may also find ways to keep your payments constant, like just reducing the number of payments. But in all cases, when you sit down to do the math, you'll find that your overall interest payments are reducing by $D \times n\%$ dollars a year.

[I wrote a mortgage calculator to test the change given all sorts of odd strategies. This was fun because it always came out to a savings of $D \times n\%$ dollars a year, no matter what trickery I tried in the payment scheme. Those situations where ten different things all turn out to be identical have to be the funnest part of mathematics.]

So the payment is very much an investment in the sense that it will pay off whatever percent every year, but you may not actually receive (or fail to lose) that money until the mortgage comes to an end. As with any long-term investment, that means you're long-term better off, but your payments and cash on hand today may not change.

You have to read the fine print on your own debt (or give your loan sharks a call), but it's the norm that you can make an early payment of principal and save the corresponding interest. If you have money to invest and believe the stock market will be rickety in the near future, then that's an eminently sensible option.

If you think the stock market will have returns greater than 12%, and your debt has an interest rate under 12%, then the advice is the opposite of the above: don't pay your debt. Say you've got \$100 to invest, a debt at 7%, and you believe the S&P 500 will return 12% in the near future. Then your options are to pay your debt, which means you don't lose \$7 and are thus \$7 up from the do-nothing option of just carrying debt and stuffing the money in your bra; or to invest the money, which means you lose \$7 in interest, but make \$12 from stocks, so you're \$12 up from the do-nothing option.

Carrying debt to invest it elsewhere requires the businesslike attitude that you've gotta spend money to make money, and that there's nothing wrong with debt. There's just a bunch of accounts, some of which have negative balances and some of which have positive. In fact, if a business *isn't* in debt, then its accountants are probably doing something wrong.

We humans are uncomfortable with debt, and most of us feel awkward paying to borrow money so we can invest it elsewhere. I wrote this whole piece because many of you won't do the rational accountant's debt-cost versus alternative-return comparison—your student loan is *oppressive*, and you want it dead. Emotions are worth something, and for many, passing on a few hundred bucks a year from playing the market is worth an early freedom from debt. And hey, if you think most of the equity alternatives are going to tank in the near future, then you're not forgoing anything at all.